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UNCLAS SECTION 01 OF 04 SAO PAULO 001005

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STATE FOR WHA/BSC, WHA/EPSC
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USDOC FOR 4332/ITA/MAC/WH/OLAC
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TAGS: EFIN EINV ECON PGOV BR
SUBJECT: CPMF DEFEAT WILL NOT BREAK LULA'S BANK

REF: Sao Paulo 768

¶1. (U) Summary: The Lula Administration suffered a serious setback on December 12 when the opposition defeated the extension of a financial transactions tax (CPMF) that brought in more than R$40 billion (approximately USD 22.5 billion) into the government coffers. Despite the revenue loss, most financial analysts are hopeful that the Brazilian government will maintain the primary fiscal surplus of 3.8 percent of GDP in 2008. Contacts tell us that healthy economic growth should result in additional tax revenue and make up part of the shortfall. In addition, the GOB could use a mix of tax hikes, cuts in discretionary spending, and cuts of transfers to state governments to cover the revenue lost due to the discontinuation of CPMF. A failure to maintain the primary fiscal surplus, however, could put off an upgrade to an investment grade sovereign credit rating, according to Moody's, but other financial institutions such as Banco Itau are less pessimistic. The economic impact for consumers will be difficult to gauge; however, the Sao Paulo business community is hopeful that the defeat will open the door for fiscal reform including a tax reform that simplifies Brazil's tax system. The full economic impact ultimately rests on the GOB's reaction and how it plans to recover from the political defeat and the loss of this significant source of government revenues. End Summary.

CPMF Defeated

¶2. (U) On December 12 in a move that surprised most analysts, the opposition parties in the Senate defeated President Lula's efforts at renewing the Provisional Contribution on Financial Movements (CPMF) tax that expires December 31. Lula's coalition was four votes shy of the needed 60 percent majority for the constitutional amendment to extend the CPMF. Even though earlier this year, Finance Minister Guido Mantega indicated that extension of the CPMF was a top priority and in September, the Lower House approved an extension through 2011, President Lula was unable to convince enough

opposition Senators to break with their party and vote to continue the tax. Seven members of the coalition also did not support the measure. The defeat is a significant political setback for the Lula Administration, who put in countless hours and resources over the last six months, and will cost the government of Brazil (GOB) more than R$40 billion in annual tax revenues. [Note: Brasilia will report the political ramifications of the CPMF defeat septel. End Note.]

¶3. (U) President Lula has publicly reassured the financial community that his Administration will maintain the primary surplus and promised to carefully evaluate all possible solutions before making any decisions. According to press reports on December 20, an initial package of options for consideration from the government's economic team (including the Ministers of Planning and Finance) to cover the R$40 billion shortfall would include recovering R$12 through tax increases, R$18 billion through public expenditure cuts, and finding the extra R$10 billion by revising the figure for estimated tax collections. The December 19 Senate passage of the DRU renewal (a constitutional amendment permitting the government to reallocate up to 20 percent of the (heavily earmarked) budget) until 2011 was crucial in any strategy to cut expenses and protect social programs. To secure passage, the government had to commit to the opposition that it would discuss proposed cutbacks with the opposition and that it would not submit the failed CPMF package as-is again for a vote. Economic Ministries are now tasked to analyze possible budget cut proposal in January with a view toward discussion and budget vote in February.

¶4. (U) When Finance Minister Mantega initially speculated publicly that taxes would have to be raised, President Lula publicly contradicted him, saying taxes would not rise in 2008. Speculation has been rife in the business and press communities that Mantega

will take the fall for CPMF's extension failure and could step down and be replaced from rumored candidates ranging from Central Bank President Meirelles to Fernando Pimentel, mayor of Belo Horizonte. [Note: A CAMEX contact of the Embassy in Brasilia said yesterday, however, that Lula complimented Mantega at a cabinet meeting December 20 and Mantega is now wreathed in smiles, appearing confident he will keep his job. End Note.]

CPMF Explanation

¶5. (U) The CPMF tax is applied to financial transactions including bank withdrawals, debits, transfers, and checks. Originally approved in 1996 for a two year period to finance public health care spending, the CPMF has been re-authorized three times (1999, 2002, 2003). The CPMF rate is 0.38 percent per transaction, is not popular with the business community, and serves as a disincentive to participation in the financial system. However, it importance to the government's budget has increased over time as Brazil relies on this revenue to help fund Bolsa Familia and health system costs. Brazilian tax officials have reported the CPMF strengthened overall tax compliance by helping to identify firms and individuals in the informal economy that previously avoided paying taxes.

Filling the Gap

¶6. (SBU) Despite initial negative reactions, financial analysts appear mostly agreed that the government should be able to maintain a primary fiscal surplus, but perhaps not the current 3.8 percent of GDP target. Merrill Lynch Economic Research analyst Virgilio Castro Cunha told Econoff the government should comfortably beat the primary surplus target this year and would likely meet it again in 2008 even without the CPMF revenues. Tomas Malaga, head of Banco Itau's Economic Research Department, told Econoffs that even at a smaller primary surplus Brazil should continue bringing down Brazil's net debt. Furthermore, Ministry of Finance economists emphasized to the U.S. Treasury Attache that the GOB has enough funds and that the GOB would collect enough additional tax revenues to "get by" without adjusting the primary surplus.

¶7. (SBU) Private sector financial analysts have predicted that the Brazilian government will likely undertake multiple measures to cover the lost revenues, including a mixture of tax adjustments, expenditure cuts, and lower transfers to other government bodies. The most likely candidate is the IOF which has a smaller tax base and could recover about 0.25 percent of GDP (about R$10 billion) in lost tax revenues. [Note: The IOF is a tax levied on credit concessions, insurance products, foreign exchange transactions and other similar transactions. Under the Fernando Henrique Cardoso administration in 1999, the GOB increased the IOF as a provisionary measure while CPMF was suspended for a few months. End Note.] According to Banco Itau's Malaga, even though raising the IOF tax would be a popular choice in Congress because its impacts are by and large felt by wealthier Brazilians and the GOB can increase this tax by decree, it ultimately could create distortions in the economy as great at the CPMF tax did. Malaga told Econoffs that the other likely tax is CSLL, which would require a simple majority approval by Congress. ABN Amro estimated these two taxes could increase revenues by about R$16 billion in 2008.

¶8. (SBU) Both Malaga and Cunha told Econoffs they expect some expenditure cuts in 2008 as well. Malaga was enthusiastic about President Lula's recent remarks suggesting his Administration would carefully weigh the next steps but would maintain the primary surplus target. Malaga opined that the GOB would ideally use this defeat to hold back its expenditures. ABN Amro estimated in its financial publication that the GOB could cut some of its discretionary outlays by as much as R$16 billion, including scraping

plans to increase investment and raise public sector salaries in ¶2008. The GOB may also limit transfers to state governments for social programs and to political parties for upcoming municipal elections, according to these analysts.

¶9. (SBU) The GOB could potentially resort to a series of other means to cover the remainder of the revenue gap including possibly reintroducing another tax similar to CPMF in 2008. Malaga reasoned that additional tax revenues from higher economic growth would mitigate some of the revenue shortage. Merrill Lynch's Cunha told Econoff that the GOB will receive more than R$65 billion in additional tax revenues this year due to stronger than expected GDP growth, and likely even more in 2008. ABN Amro suggested the government could also reduce investments for its state-owned enterprises, including Petrobras. Furthermore, Cunha underscored the GOB's inability to execute its 2007 investment budget and expected it would have the same difficulties in 2008.

Investment Grade Requires Fiscal Discipline

¶10. (SBU) Luiz Tess, Moody's Brazil Representative Director, told Econoff that maintaining fiscal discipline continues to be the most important determinant of whether Brazil receives an investment grade sovereign credit rating. He noted that the GOB's failure to secure CPMF renewal doesn't hurt automatically Brazil's chances for an upgrade, but it does create more uncertainty and puts more pressure on the government to keep its fiscal targets in-line. [Note: This position has not changed demonstrably from Econoff's meetings with Moody's in September (reftel). End Note.] Banco Itau's Mauricio Oreng, on the other hand, does not expect a change in the primary surplus target and has not altered his prediction for a sovereign credit rating in 2008.

Household-level Impacts of No CPMF

¶11. (SBU) Because many Brazilians do not participate in the formal financial system (two-thirds of Brazilians do not have bank accounts), the impact of not paying the CPMF tax may not be dramatically felt at the individual household level. However, Malaga pointed to a potential indirect increase in demand as consumers have more money to spend. [Note: The Brazilian Institute of Tax Planning (IBPT) estimated the average Brazilian paid R$172 in 2006 in CPMF. End Note.] The CPMF has a cascading effect across

the entire value chain of a final good's production. The influential Brazilian magazine Veja in a report in September calculated that the total CPMF tax was approximately two percent of the total price of finished products, after aggregating across all steps of the production process. Planning Ministry officials have noted that CPMF revenues represent 1.5 percent of Brazilian GDP. At the margin, however, Cunha said it would be hard to define the direct and indirect impacts without CPMF because the Brazilian economy has been outperforming expectations.

¶12. (U) Financial institutions and businesses that bore the admittedly light administrative burden of collecting CPMF should feel some relief. On average, tax compliance in Brazil for companies requires 2600 hours per year--the largest figure in the world and eight times more than is required in the U.S.

¶13. (U) Despite CPMF's explicit goal to help improve healthcare, the revenues were collected into the central Treasury where they were redistributed. Many of the tax's critics note the revenues do not actually contribute directly to healthcare. For instance, as reported by Veja, even with CPMF revenues in hand, the Ministry of Health failed to meet its four healthcare goals. In reviewing areas for potential budget cuts, protecting the health sector is a stated opposition priority and a political necessity for the Lula government.

Tax Reform Impact

¶14. (SBU) Both Malaga and Cunha noted the defeat could prompt the Lula government to broach some form of tax reform in 2008, a welcome sign in a country where the tax burden is 35 percent of GDP. Cunha noted the defeat might give the GOB enough room to come to the negotiating table. Vice-President of the Sao Paulo Federation of Industries (FIESP), Saturnino Sergio da Silva, told Econoffs the defeat opens the door to discuss other pending business for the country, including tax reform and infrastructure development. The federal government's buy-in to any tax reform negotiation with state and municipal governments is essential because federal taxes comprise three-quarters of total tax revenues, he said. On the other hand, other analysts in Brasilia have speculated that failure of the CPMF will lead to indefinite delay in the government tabling the tax reform package it reportedly already has ready (originally intending to table it once CPMF was passed) and to lack of willingness to consider tax reform measures that would further lower short-term revenue collections even if they encourage longer-term growth.

Comment

¶15. (SBU) The defeat of the CPMF renewal leaves the GOB fumbling for answers, while the business community cautiously awaits the GOB's response. Lula invested significant political time and capital to extend the CPMF. The controversial vote came at a time where the Brazilian economy is seeing tax revenues growing, economic growth picking up, lower inflation, and falling (though still high) interest rates. These factors mitigate to some extent the loss of this CPMF revenue.

¶16. (SBU) The economic impact and financial sector's reaction ultimately hinge on the Brazilian government's reaction. However, as Brazil heads into the holiday season, we are unlikely to see any real movement in tackling this issue until after Carnival in early-February when business returns to normal in Brazil. If the GOB did decide to tinker with the primary surplus target, as currently appears unlikely, it could face serious consequences including a possible sovereign credit downgrade, an interest rate hike, and a retreat in international capital flows. However, given what appears so far to be a pragmatic approach to dealing with this issue both politically and economically, post believes the economic impact of the loss of the CPMF tax is likely to be minimal. End Comment.

¶17. This cable was cleared by the Treasury Attache in Sao Paulo and the Embassy in Brasilia.

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